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Generating Larger Tax Revenue in South Asia¹

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Development Economics, World Bank

Abstract

Despite repeated attempts, South Asian countries have managed only limited and sporadic success in mobilizing larger tax revenue. Tax-to-GDP ratios in most countries in the region remain below cross country averages and are considered inadequate to meet their financing needs. Underperformance in tax revenue generation does not seem due to paucity of tax policy reforms. South Asian countries have undertaken considerable reforms in the last decade, and their tax structures have converged with the rest of the world. But they have been less successful in widening their tax base, in strengthening tax administration, and in improving compliance. Additionally, structural factors such as large share of agriculture, low literacy, and large informal sectors have hindered tax collection. Further efforts in the region to increase tax revenue ought to be wider in scope than before and should extend to the subnational and local governments. They should focus on simplifying tax systems, strengthening tax administration, and broadening the tax base. These efforts should be situated within a wider reform program that aims to strengthen governance, improve business environment and help formalize their economies.

Keywords: South Asia, Tax Revenue, Tax Policy

JEL Classification: H2, H6, H24, H26

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1. Introduction

A tax system is considered optimal if it generates adequate revenues to meet a country's public spending needs; is efficient; progressive; and easy to administer and comply with. Judged against the first yardstick, the South Asia Region (SAR) has not been uniformly successful in generating adequate tax revenue. Despite impressive GDP growth in the past decade, growth in tax revenue has been sluggish, and their tax-to-GDP ratios have either stagnated or declined. Even though the smaller countries in the region, Afghanistan, Bhutan, Nepal and Maldives, have been moderately successful in increasing tax-to-GDP ratio, it has either stagnated or declined in the larger economies. It remains low in Pakistan and Sri Lanka, and after some initial increase, has begun to stagnate in Bangladesh and India. Underperformance in revenue mobilization extends to all kinds of taxes--direct, indirect, and property taxes.

This paper asks why do SAR countries lag in tax revenue collection relative to their level of development. It assesses their tax policy regimes, analyzes past reforms, and discusses the areas where further reforms ought to be undertaken.

Tax generation in South Asia remains low despite the fact that currently their tax regimes are not considered very different from those in other countries. South Asian countries have implemented comprehensive tax reforms in the past 1-2 decades, either on their own or as a part of the ongoing policy dialogue with the World Bank and the IMF. They have pursued the trends prevalent worldwide by transitioning their indirect taxes towards the value added tax (VAT); lowering taxes on international trade; and rationalizing personal and corporate income taxes. The main reasons for low tax revenue are that the countries have been less successful in broadening their tax base; improving compliance; simplifying and strengthening tax administration; initiating wider governance and regulatory reforms; and modernizing their economies that could help increase the tax coverage.

Weak tax administration is considered a key barrier to effective and fair tax collection in the region. Tax administration and tax compliance is weak due to lack of technical expertise and financial resources, as well as due to corruption. Tax administrative capacity at subnational and local government levels is particularly wanting. Even if in principle tax structures are progressive, collection from the rich is low due to widespread evasion, keeping the collection of income tax low. Though some progress has been made in making tax administration simpler in recent years, SAR continues to lag behind other regions.

Besides extensive exemptions and weak tax administration, several structural factors have impinged on the region's tax revenue performance. These include large share of agriculture (a historically undertaxed sector) and service sector (a lightly taxed sector); low literacy rate; large rural population; large informal economy partly due to onerous regulations on businesses, including labor regulations; high corruption; and low financial development, due to which financial transactions are conducted in cash, making it difficult to track tax evasion. These factors keep a large proportion of the population and economic transactions outside the tax net. There are political factors at play as well, reflected in a small base of registered as well as actual tax payers, especially in the larger countries in the region. In what seems to be a feature somewhat unique to SAR countries, taxpayers enjoy a plethora of exemptions, which are often used to compensate for the relatively weak business environment and constitute an integral part of industrial policy. Exemptions have not only narrowed the tax base, but have also made the tax systems more complex and increased resistance for further reforms.

There is need for next generation of tax reforms in SAR that ought to aim at not just strengthening the ongoing tax policy reforms but also at improving tax administration and compliance; increasing the tax base by rationalizing exemptions and increasing tax coverage. It should seek for greater engagement of the subnational and local governments; and aim at broader governance and structural reforms. Tax policy reforms per se should seek to broaden the tax base not just by bringing a larger population under the tax net, but also by increasing the scope of taxes to activities that are currently undertaxed (e.g. by extending VAT to retail and wholesale trade or income tax to service professionals); and by further rationalizing the direct and indirect taxes and extending the scope of property taxes.

One word of caution is warranted though. Going by the past experience, gains that might accrue from tax reforms may still not be adequate, timely or durable to raise sufficient revenues to finance region's infrastructure deficit or its development needs. Hence it would be equally important for the region to explore additional means of long term financing.

Some caveats are in order too. First, data used in estimating the relationships between tax revenue and other variables differ somewhat across different taxes because of the different availability of data for different tax components (leading to small discrepancies in adding up the tax revenue gaps for different taxes to total tax revenue gap). Second, we have deliberately kept the econometric analysis simple by estimating separately the tax to GDP ratio for each type of tax (alternatively, one could have estimated tax revenue for each tax in a unifying framework, say by using the seemingly unrelated regressions). Finally, while we have only presented results from bivariate regressions, these can be easily extended to more comprehensive multivariate analyses.

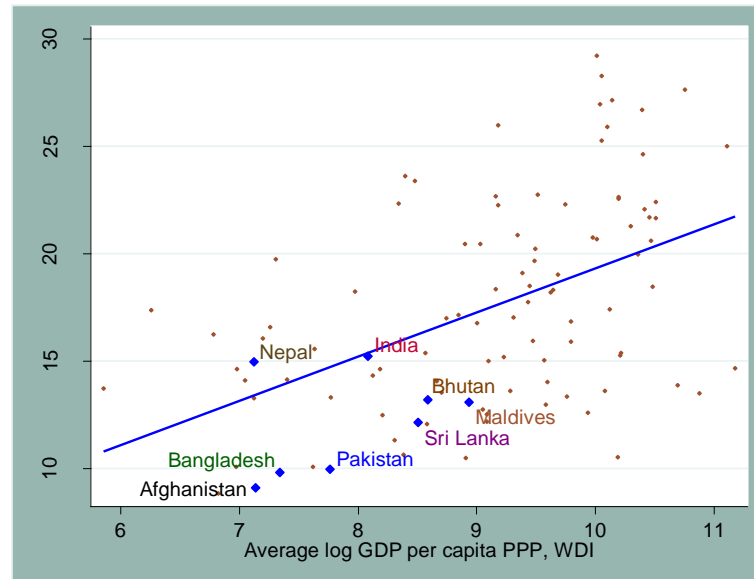
The rest of the paper is organized as follows. Section II discusses recent trends in total tax revenue as well as in its different components in SAR and compares them with the trends in other countries. Section III discusses the factors responsible for low tax revenue. Section IV concludes.

II: Levels and Trends in Tax Revenues Globally and in SAR

Tax-to-GDP ratio is low in South Asian countries when compared with other countries at similar levels of development (Chart 1), as well as when judged against their own financing needs. With the exception of Nepal and India, all other countries in the region are below tax-to-GDP ratios observed in other regions at comparable income levels, by 3.2 to 4.8 percentage points.² Based on the relationship between the level of per capita income and tax-to-GDP ratio, we calculate the average difference between the estimated and actual tax ratio to be nearly 3 percentage points for all SAR countries and 4 percentage points excluding Nepal and India.

² We have used a simple linear approach to find average tax-to-GDP ratios at different income levels. In a different approach Bird and Zolt (2003) compute average tax ratios for different slabs of low income, middle income and high income countries. They estimate that the countries with per capita incomes upto 1000 USD have an average tax ratio of 17%; countries with per capita incomes between USD 1000 and USD 17,000 have a tax ratio of 22%; and the countries with higher income levels have a tax ratio of 27%. By this metric the tax ratios in most South Asian countries are lower than our estimates. Yet another approach to find tax gaps is to analyze the tax capacity, tax effort and tax gaps, as in Fenochietto and Pessino (2004).

Chart 1: Tax-to-GDP Ratio is Low in SAR when Compared with other Countries



Note: Data sources are World Development Indicators, Government Financial Statistics and IMF Country Reports. Data are averages of 2010-12. The linear relationship is estimated for 102 countries (after dropping outliers), for which the data on tax/GDP are available. The estimated linear relationship is $\text{Tax/GDP} = -1.2 + 2.05 \text{ Log GDP per capita}$, the coefficient of log GDP per capita is significant at 1 percent level.

Despite impressive gains in per capita income in the region, tax-to-GDP ratios have not seen a strong momentum. Even as per capita income (in constant USD) grew at an average annual rate of 4.4 percent in South Asian countries in the last decade, the average annual increase in tax-to-GDP ratio has been a meagre 0.14 percentage points. Expectedly, these regional averages mask important heterogeneity within the region, as seen in Table 1 below.

Table 1: Tax Revenue has not kept pace with Per Capita Income Growth (constant USD) in SAR

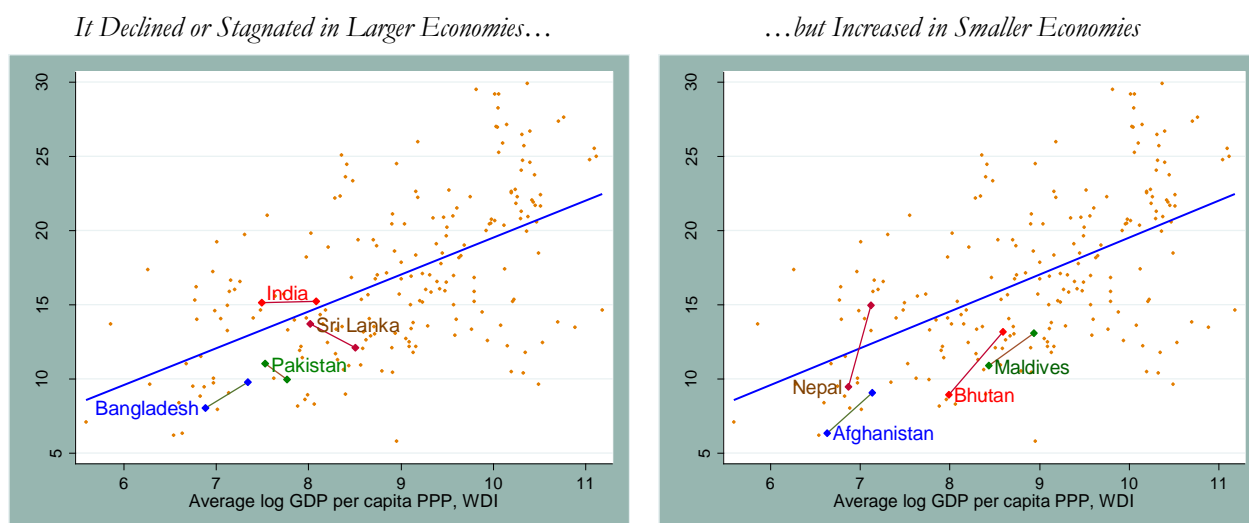
	Per Capita Income in 2000	Per Capita Income in 2010	Average Annual % change in Per Capita Income 2000-2010	Tax/GDP in 2000 (in percent)	Tax/GDP in 2010 (in percent)	Average Annual Change in Tax/GDP 2000- 2010 (% points)
Afghanistan	232	361	4.52	2.8	9.4	0.66
Bangladesh	350	539	4.41	6.7	9	0.23
Bhutan	992	1795	6.11	11.1	13.5	0.24
India	578	1034	5.99	14.2	15.1	0.09
Maldives	2871	4663	4.97	13.8	10.7*	-0.31
Nepal	297	376	2.39	8.7	14.8	0.61
Pakistan	597	748	2.28	12.7	10.1	-0.26
Sri Lanka	1052	1610	4.35	14.4	12.9	-0.15

Note: Sources are World Development Indicators, International Monetary Fund country reports, Government Finance Statistics. General government tax revenue is used for Bhutan, India, Maldives, and Pakistan; central government tax revenue is used for Afghanistan, Bangladesh, Nepal, Sri Lanka. Per capita income growth is cumulative average growth rate. * Maldives' tax-to-GDP ratio has improved markedly in recent years and was 15.5 percent in 2011.

In Chart 2 below we compare the increase in tax-to-GDP ratio in South Asian countries in the last decade with the increase observed in other countries. We estimate a linear relationship between tax-to-GDP ratio and log per capita income using data at two points in time, averages for 2002–04 and 2010–12; and compare the actual ratios in SAR with their estimated values.³ For ease of exposition we plot the data for SAR countries in two different panels in Chart 2 below, one for Bangladesh, India, Pakistan and Sri Lanka and another for the four remaining countries: Afghanistan, Bhutan, Nepal and Maldives.

While globally, tax-to-GDP ratio has increased with income levels, this has not been the case for all countries in SAR. Smaller economies, Afghanistan, Bhutan, Nepal and Maldives, have been relatively more successful in increasing their tax to GDP ratios in the last decade, albeit starting from a low base and possibly because it was easier for them to reap the initial dividends of economic growth and tax reforms. In the larger economies, tax ratios have either remained stagnant or declined. The tax ratios have declined in Pakistan and Sri Lanka, and after some initial increase have stagnated in Bangladesh and India.⁴ We see similar trends in annual data in Chart 3 below.

Chart 2: Mixed Patterns Observed in Tax-to-GDP ratio in South Asian Countries



Note: Sources are World Development Indicators, Government Financial Statistics, and IMF Country Reports. Data are averages of 2002–04 and 2010–12. SAR tax revenue data come from multiple IMF country reports. Data for 2006–08 is used for Afghanistan instead of 2002–04.

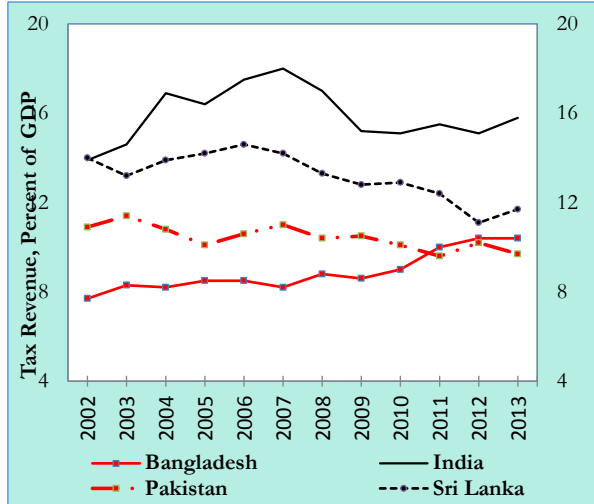
Similar trends are observed in the collection of different types of taxes as well—direct, indirect, and property taxes. Trade taxes are somewhat higher than the cross country average in most SAR countries (except India and Pakistan); all countries lag in the collection of indirect taxes (except Nepal and India); and, with a couple of exceptions all countries lag in the collection of property taxes as well.

³ We allowed the linear relationship to shift over time, but these shifts were not very pronounced. We also estimated a nonlinear relationship between tax/GDP and log per capita income, but it yielded an almost identical fit. Finally, we estimated a linear regression for total revenue, and benchmarked SAR countries against the cross country averages, which generated a similar picture as well.

⁴ The underlying data is in Table 2 in the Appendix. The ratio of total revenue to GDP has evolved similar to the tax revenues across SAR and is shown in Appendix Table A2.

Chart 3: Mixed Patterns are observed in Tax-to-GDP ratio in SAR in the Last Decade

Stagnant or Declining in Larger Economies...



...Increasing in Smaller Economies

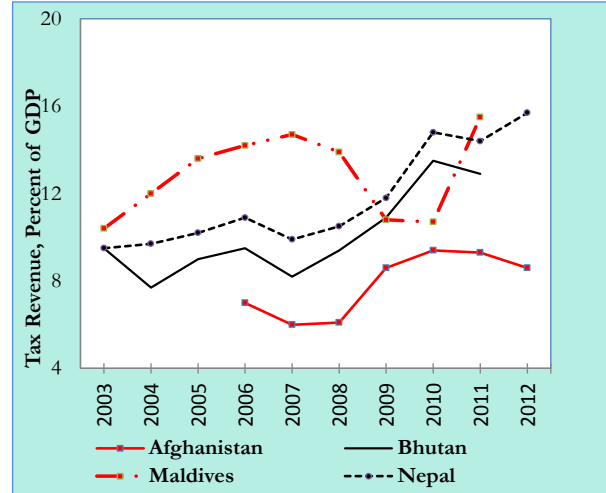
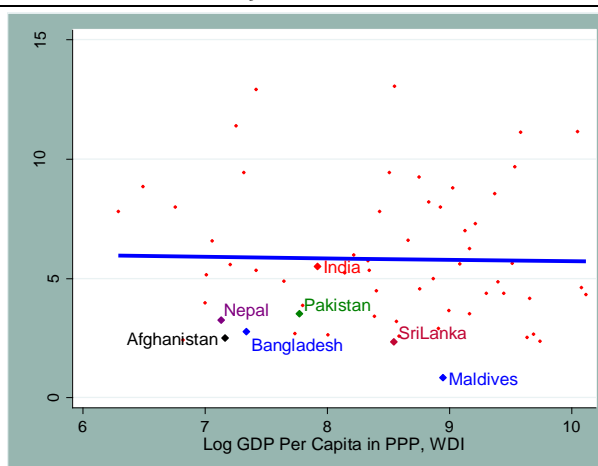
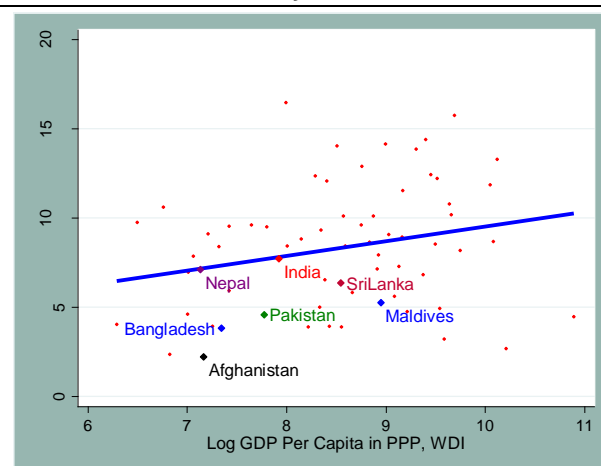


Chart 4: Tax Revenue in SAR Countries Lags for Different Kinds of Taxes

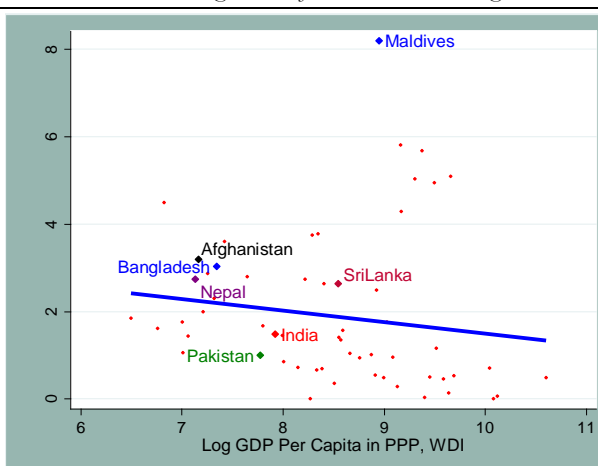
Collection of Direct Taxes is low...



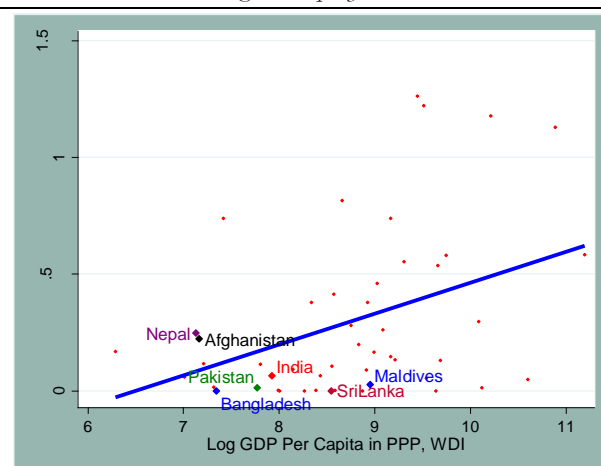
As well as that of Indirect Taxes...



while revenue generated from trade taxes is high..



but lags in Property Taxes



Sources are World Development Indicators and Government Financial Statistics. Data are averages of 2010–12.

III. Understanding the Factors behind the Low and Sluggish Tax-to-GDP ratio in SAR

In order to understand the factors responsible for the low and sluggish tax revenue in South Asia, we express total tax revenue in each country as the sum of tax revenue collected on different activities, i.e. the sum of tax rate multiplied by tax base, for each activity k .⁵

$$Tax\ Revenue = \sum_k (Tax\ Revenue_k) \quad (1)$$

Tax revenue on each activity is a function of the tax rate on the activity, tax rates on other relevant activities (to account for tax arbitrage), and its tax base. In Equation 2, g_k is a non linear function of tax rate. A decrease (increase) in tax rate may increase or decrease the tax revenue depending on whether it increases (decreases) the tax base more than or less than proportionately.

$$\begin{aligned} Tax\ Revenue_k &= tax\ rate_{k,j} * tax\ base_k \\ &= g_k(tax\ rate_k, other\ factors) \end{aligned} \quad (2)$$

Tax base could depend on a multitude of factors besides tax rate, such as exemptions, tax coverage, and compliance. Tax base of activity k may thus be written as below:

$$Tax\ base_k = f(tax\ rate_{k,j}, exemptions_k, tax\ coverage, compliance) \quad (3)$$

Based on this taxonomy, the main reason behind low tax revenue in SAR countries is believed to be their small tax base, which has not increased proportionately more than the decline in tax rates, and which continues to be eroded by extensive tax exemptions, weak compliance, as well as by structural factors.

(i) Tax Rates and Structures in SAR

In the past two decades the tax structures in SAR have evolved, and continue to do so, consistent with the global trends. These include decline in rates of trade taxes, and a commensurate decline in the contribution of trade taxes to total tax collection; rationalization and declines in the statutory tax rates of income tax and corporate tax rates; and wider adoption of VAT, which has come to replace the existing indirect taxes including excise and sales taxes. Countries at higher income levels have been able to successfully levy property taxes and collect a significant amount of revenues through them. Different tax rates and the composition of taxes in South Asian economies are also considered similar to those observed in East Asia.

⁵ The base here is the effective base (net of evasion and avoidance), not the statutory base.

Table 2: Tax Rates in South Asian Economies Have Converged

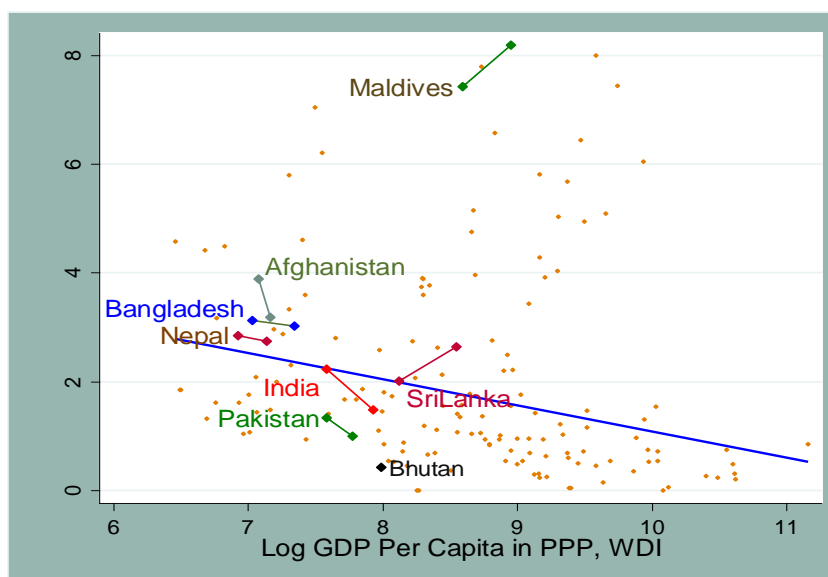
<i>Country</i>	<i>Maximum PIT rate</i>	<i>Maximum CIT or representative rate CIT rate</i>	<i>Representative VAT or Sales tax</i>	<i>Average Import tariff (%)</i>
Afghanistan	—	—	—	—
Bangladesh	25	27.5	15	23.9
Bhutan	25	30	—	21.9
India	30*	33.9	12.5	18.5
Maldives	—	25	—	16.9
Nepal	25	25	13	12.4
Pakistan	25	35	16	14.7
Sri Lanka	24	28	12	11.4

Source: South Asia Economic Focus, 2012. Data refer to rates approximately in 2011. In comparison the average East Asia CIT average is 24% ; and the maximum PIT rate is 29 %. * In India there is an additional education surcharge of 3%.

Trade Taxes

Average tariff rates have been declining in SAR, and at between 10-25 percent, are considered reasonably low. Contribution of trade taxes in total revenue collection has declined overtime, and this trend is likely to continue with further scaling back of trade taxes and expansion in regional trade agreements. Countries however have not been able to recoup the decline in revenue from trade taxes by other direct and indirect taxes, hampering further progress in reducing trade taxes. Maldives most prominently but also Afghanistan, Nepal, Bangladesh, Sri Lanka, still garner a larger than average share of revenue through trade tax (Table A3 in the Appendix).

Chart 5: Revenues from Trade taxes have declined in SAR with some exceptions



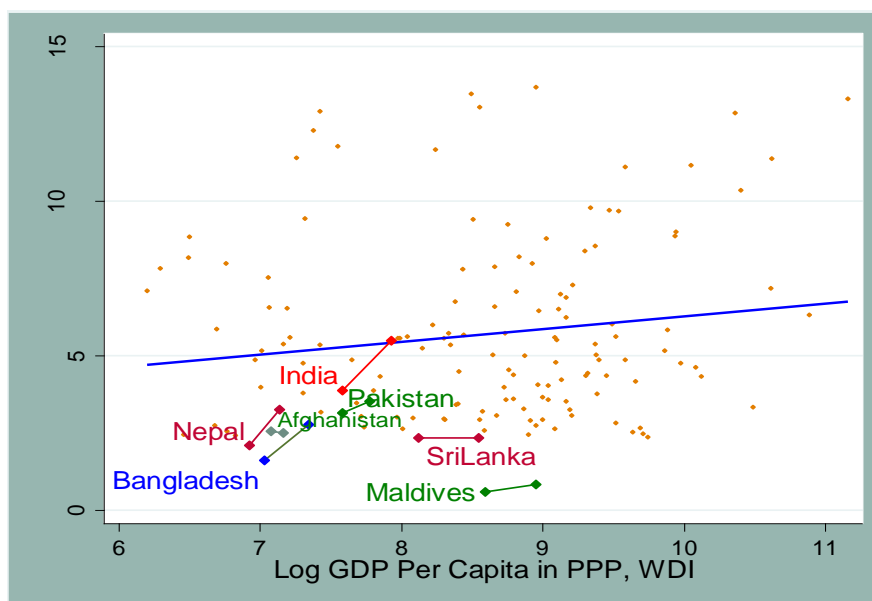
Source: World Development Indicators; Government Financial Statistics; data averages of 2000-2002 and 2010-12.

Direct Taxes

Among direct taxes in SAR, personal income tax (PIT) and corporate income tax (CIT) have been simplified and rationalized extensively over the past years. As a result, income tax rates are no longer considered prohibitive and their structures are considered relatively simple (except in Pakistan and Sri Lanka). Tax experts advise that CIT and income tax rates should be set such that there are no arbitrage opportunities in moving across these taxes; accordingly, the effective maximum PIT rate should be set close to the effective maximum CIT rate. In South Asia, the top corporate income tax rate and personal income tax rates are generally close to each other, limiting the prospects for tax arbitrage.

Globally, direct taxes have contributed a larger share to tax revenue overtime as taxes have been rationalized, and their base widened (particularly by covering incomes earned by professionals).⁶ In our estimates of the relationship between log per capita income and direct tax revenue-to-GDP ratio, we obtain a positive relationship, which albeit is flatter, than that between total tax revenue and per capita income.

Chart 6: Several South Asian Countries have succeeded in increasing their Direct Tax Revenues but some have not



Source are World Development Indicators and Government Financial Statistics. Data are averages of 2000-2002 and 2010-12. The estimated linear relationship is $\text{Tax/GDP} = 2.14 + 0.41 \text{ Log GDP per capita}$, coefficient of log GDP per capita is significant at 10 percent level.

In Chart 6 we track the increase in direct tax-to-GDP ratio and per capita income growth in SAR countries at two points in time, early 2000s and late 2000s (Bhutan is omitted due to unavailability of data during these periods). We note that direct tax collection has increased modestly in South Asia over time.

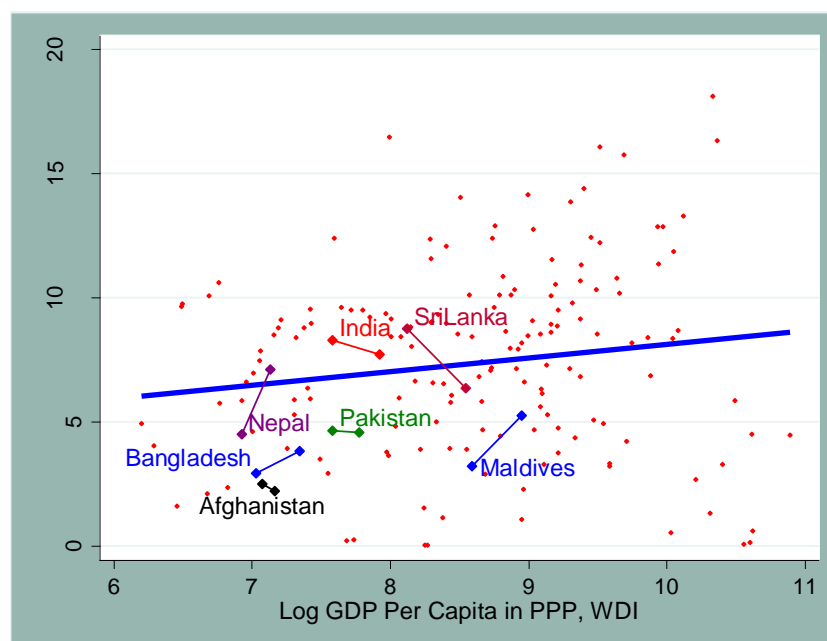
⁶ In OECD countries, decline in statutory rates has been more than offset by broadening of tax base through a scaling back of exemptions. As a consequence, corporate tax revenue collected in OECD countries increased from an average 2.5 percent of GDP in early 1990s to 3.4 percent in early 2000s. On the contrary, in developing countries, decline in statutory rates have coexisted with narrow tax base, leading to decline in corporate revenue-to-GDP ratio.

India, Nepal, and Bangladesh have been relatively more successful in increasing the collection of direct taxes. India's strong performance is attributed to significant improvements in tax administration; and to robust economic growth in the recent past. Another country which has been reasonably successful in increasing the share of direct taxes is Nepal. Pakistan's adoption of a low and uniform CIT rate (35 percent) had a visible positive effect in earlier years of its adoption, but the effect has tapered off in recent years. Sri Lanka's efforts to increase income tax collection (for example, by increasing the tax coverage to include civil servants) had some early positive effects as well, but the effects did not prove lasting, and the direct tax revenue to GDP ratio has remained flat in the last decade.

Indirect Taxes

One of the most successful tax reforms worldwide has been the replacement of production and sales taxes by VAT. In 2007 there were 143 countries in which VAT was operating in some form, and the number has only increased overtime. Even though VAT has been rolled out in a large number of countries, its coverage remains narrow, with a number of activities outside the tax net. Experts advise that the coverage of VAT should be broadened by bringing a wider set of goods and services under its ambit, including wholesale and retail trade which are often outside the tax net in developing countries. Coverage of VAT is narrow in SAR as well, and is often confined to the first point of sale (manufacturing or import) rather than extending to the whole value chain.

Chart 7: With Some Exceptions, Indirect Tax Revenue Ratio in SAR has Declined



Sources are World Development Indicators and Government Financial Statistics; data are averages of 2000-2002 and 2010-12. Estimated linear relationship is $\text{Tax}/\text{GDP} = 2.7 + 0.54 \text{ Log GDP per capita}$, coefficient of log GDP per capita is significant at 5 % level.

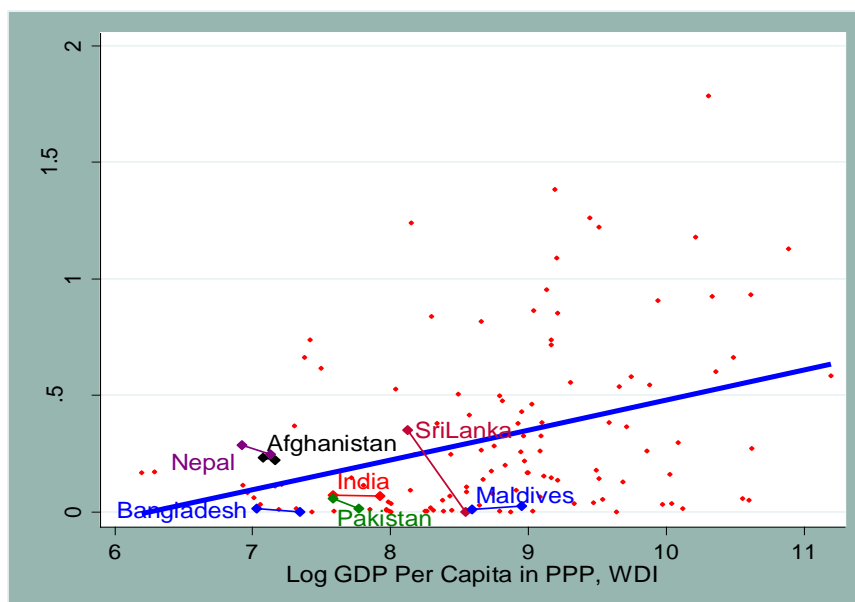
While most countries in SAR, except India and Nepal, lag in the collection of indirect tax as percent of GDP, Nepal, Bangladesh and Maldives have succeeded in increasing this ratio in the last decade. Among

the worst performers are Sri Lanka, where indirect tax revenue as percentage of GDP has declined, and Pakistan where it has remained flat.

Property Tax

Once a country reaches a certain level of development and meets the required cadastral and valuation standards to levy and collect property taxes, it can generate a fraction of revenues through property taxes. Property taxes are considered least damaging to growth and meet the criteria of both efficiency and equity well. OECD countries, e.g. raised between ½ to 4 percent of GDP in 2000-2008 in revenue (both recurrent and non-recurrent) from property taxes (largest collection being 4 percent of GDP in Great Britain).

Chart 8: Revenues from Property Taxes in South Asian Countries have been Minuscule



Source: World Development Indicators; Government Financial Statistics; data averages of 2000-2002 and 2010-12.

Property tax revenue can help strengthen local government finances and finance infrastructure development.⁷ According to Rao (2013) “The design and implementation issues relating to property tax is one of the relatively less researched areas. This is particularly so in developing countries where the property market is largely unorganized and therefore, valuations are extremely difficult, information available to the tax authorities is restricted, extent of decentralization is limited, the local elite or “distributional coalitions” are powerful and there are serious capacity limitations for the levy designing and implementing the property tax.” It is not surprising then that SAR collects very little revenue in property taxes. Property tax collection is minuscule in all South Asian countries, and lower than the average in other countries (except Nepal and Afghanistan) with considerable scope for increases.

⁷ See Norregaard (2013) on the revenue potential and the challenges in implementing property taxes.

(ii) Factors that Impinge on the Tax Base in SAR include Extensive Tax Exemptions, Inefficient Tax Administration and Poor Compliance

A tax structure is considered effective and efficient if it is simple and comprises of few rates and few exemptions. Thus countries should eliminate smaller taxes and fees which do not contribute significantly to revenue, but broaden the base for other taxes. SAR countries tax structures do not meet these requirements. In what seems like a feature somewhat unique to SAR countries, tax payers enjoy a plethora of exemptions. While the business environment is considered generally poor and not conducive to operate businesses in the formal sector, exemptions are often used to favor specific activities and constitute an integral part of their industrial policy. Given weak governance in most SAR countries, exemptions have been used for preferential treatment of often underserving businesses, and have proven difficult to phase out. In reforming the tax systems in SAR, exemptions ought to be rationalized and not treated as a substitute for good governance, business environment, or infrastructure. This view is echoed in Tanzi and Lee (2000) who concur that, “the cost-effectiveness of providing tax incentives to promote investment is generally questionable. The best strategy for sustained investment promotion is to provide a stable and transparent legal and regulatory framework and to put in place a tax system in line with international norms.”

Weak tax administration could be a barrier to effective and fair tax collection. A cumbersome or inefficient tax administration deters compliance and encourages evasion. Tax administrative capacity at subnational and local government levels (where applicable) is particularly wanting in SAR. On a few common yardsticks of tax administration, such as the number of payments per year, or time spent per year filing taxes, reported in the World Bank’s doing business indicators, South Asian countries rank particularly low.

All SAR countries rank below median in ease of paying taxes, and several figure in the bottom quartile of the 189 countries ranked in the database. Tax underperformers in the region, Pakistan and Sri Lanka, particularly rank low on the indicators of ease of paying taxes as well. For a typical firm in the *Doing Business* exercise, time spent preparing and paying taxes is about 200 hours in developing countries, compared to 166 in advanced countries, but is substantially larger in SAR. While advanced economies and East Asian economies continue to streamline their tax payments, the progress has been less impressive in South Asia.⁸

There is an undeniably urgent need to strengthen tax administration in SAR economies. Keeping with the tax administrative reforms in countries around the world, tax administration in South Asia should be strengthened along the following lines. The requisite institutional arrangements and organizations for tax administration should be set up and allowed to work independently. This has been done in several countries by establishing semiautonomous legal entities (often called the *revenue authorities*), which are insulated from political influences. Contrarily, in South Asia tax administrators are generally attached to the ministry of finance with limited independence, and thus often operate with limited financial and technical resources. In order for them to work more effectively they ought to be granted operational independence as well as adequate financial and technical resources, so that they could invest in data collection and assessment capacity.

⁸ The Paying Taxes report of the World Bank Group and PwC, published in November 2013, notes that scores of economies have taken steps in the last year to make it easier and less costly for small and medium businesses to pay taxes. The progress is commendable since it was made amidst global economic slowdown.

Table 3: Ease of Paying Taxes in South Asia

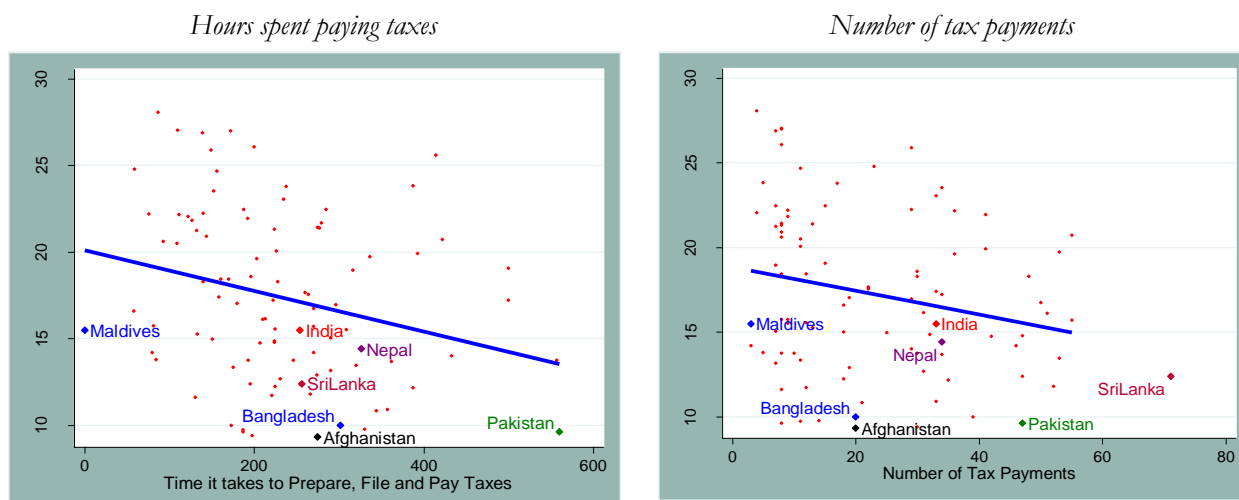
	Overall Ranking (total countries 189)*	Number of Payments per year		Time Spent per year (Hours)	
Doing Business Report Year	2014	2006	2014	2006	2014
Afghanistan	98	17	20	275	275
Bangladesh	100	20	20	400	302
Bhutan	104	19	19	274	274
India	158	55	33	264	243
Maldives	115	3	30	0	413
Nepal	126	34	34	408	326
Pakistan	166	47	47	560	577
Sri Lanka	171	58	58	256	210
South Asian Countries		32	33	305	328
South Asian Countries w/o Maldives**		36	33	348	315
East Asia and Pacific Countries		28	25	291	208
Developing Countries		40	32	370	310
Advanced countries		19	15	222	166

Note: Source is Doing Business database. Developing countries are those with 2012 GNI per capita levels, calculated using the World Bank Atlas method, below \$12,615. Tax payments by businesses are the total number of taxes paid, including electronic filing. Time to prepare and pay taxes is the time (in hours per year), it takes to prepare, file, and pay (or withhold) three major taxes: the corporate income tax, the value added or sales tax, and labor taxes.* A higher number is a worse ranking in ease of paying taxes. **Maldives introduced corporate income, labor and consumption taxes in late 2011, the increase in time to comply and number of payments is it being a full year of filing for consumption taxes in 2012 (with electronic filing the time is likely to decline in future).

Successful examples from around the world have demonstrated that information technology can be used to improve tax administration through electronic filing, e-payments and refunds, and virtual tax offices. There has been limited progress in moving to e-tax administration in South Asia due to low literacy and e-literacy, and lack of financial and technical resources. Some countries have strengthened their tax collection by setting up large tax payer units in order to tax high-turnover businesses more effectively, and to strengthen detection and enforcement. This could be particularly relevant for SAR where compliance among rich and large taxpayers is particularly low.⁹ Finally, it is important to complement tax administrative reforms by not just making compliance easier, but also tax evasion difficult and costly; and by simplifying the dispute settlement mechanism and appeals procedures, whose success may impinge on broader judicial reforms.

⁹ Even if in principle tax policy might be progressive in developing countries, tax collection of income tax and property tax from the rich is low due to widespread evasion. The same phenomenon prevails in SAR.

Chart 9: South Asian countries rank low in ease of paying taxes, which impacts their tax revenue collection¹⁰



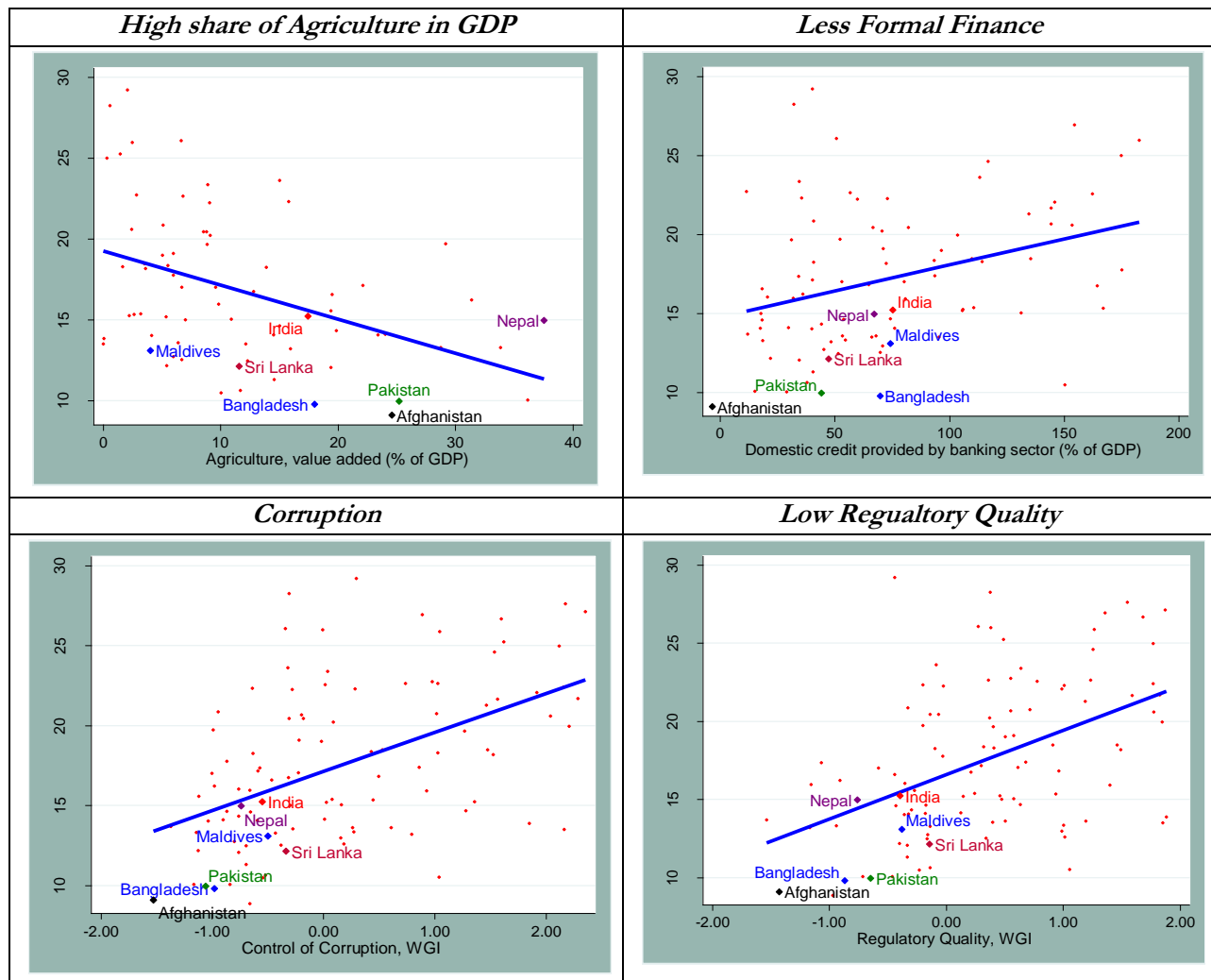
Note: Sources are Doing Business, World Development Indicators, Government Financial Statistics, and IMF Country Reports. Data for tax revenue in SAR are obtained from multiple IMF country reports.

(iii) Structural factors

Some challenges that are unique to developing countries in broadening their tax base, and are relevant to SAR as well, including a agriculture sector, which is historically undertaxed, and large services sector, which is a lightly taxed sector; low literacy rate (making compliance weak); inequality, which erodes the base of the income tax; a large share of rural population, keeping tax coverage narrow and tax administration complex; a large informal economy, partly because of onerous regulations; corruption; low financial development due to which financial transactions take place in cash, making it difficult to control tax evasion. These factors keep a large proportion of economic transactions outside the tax net keeping revenues low. Several of the factors relate to broad economic and social structure of the economies and are outside the purview of tax policy and tax administration. Governance reforms, strengthened business environment, and reforms that help formalize and modernize their economies would help improve tax revenue outcomes in the region.

¹⁰ We included all countries in the chart for which we had data on tax revenue, but dropped countries with more than 60 payments or with more than 500 hours spent in paying taxes in 2011.

Chart 10: Tax Revenue in SAR Countries Lags for Different Kinds of Taxes



Note: Source for agriculture's share in GDP, banks credit, regulatory quality, corruption, and urbanization is World Development Indicators and for the tax data is Government Financial Statistics. Data are averages of 2010–12.

As Chart 10 shows, size of agriculture in GDP is correlated negatively with tax-to-GDP ratio, perhaps unsurprisingly, since a large share of agriculture is indicative of low per capita income and small urban population, and because GDP generated in agriculture is historically undertaxed. While overtime SAR countries have managed to lower their dependence on agriculture, the trend needs to continue for robust tax revenue generation.

A large share of urban population is associated with a larger collection of taxes due to the fact that the urban population is more educated and is employed in the formal non-agricultural sector, ensuring a larger tax base and tax compliance. The urbanization rate is quite low in SAR and with some exceptions has not increased rapidly in the last decade. A large financial sector is also associated with a large tax-to-GDP ratio. We proxy the size of the financial sector by the domestic credit provided by banking sector as percent of GDP and observe that the financial sector is underdeveloped in SAR countries. The countries which have succeeded in increasing the size of their financial sector in the last decade are Nepal, and Bhutan and Maldives, the same countries have also managed to increase their tax ratios.

Special interest group politics is also responsible for narrow tax base and low revenue collection. Specifically in India and Pakistan strong farm lobbies make it difficult to tax income from agriculture. In India, the power to levy income tax on farm incomes is accorded to the states by the constitution. The states in turn are reluctant to tax agricultural income, ostensibly because the size of land holdings are small and net income per farmer is small and unstable. The argument has lost relevance overtime with farm activity getting concentrated, and with larger companies getting into farming. A recent study by Rao and Sengupta (2012) estimates that taxes on farm income could generate an additional revenue of one percent of GDP in India. Similarly, incomes generated from agriculture in Pakistan are undertaxed due to powerful farm lobby despite the fact that the size of holdings are large.

IV. Underpinnings of a Second Generation of Reforms and Country Specific Reforms Priorities

Any good tax reform should attempt to minimize the collection (administrative) and compliance cost. Administrative cost can be minimized by greater use of technology; compliance cost can be lowered by making the tax system simple and stable and minimizing the interface between tax payers and collectors. It also requires that the tax system should not be loaded with multiple objectives such as encouragement to certain types of industries or businesses, enclave development, backward area development, infrastructure creation, choice of technology, small scale industry promotion, employment creation etc. Tax preferences render the tax base narrow; complicate the tax system and increase the compliance and administrative cost; and distort choices. A best practice approach to tax policy design and reforms is one in which the tax system is broad based, but with low and less differentiated rates and is simple, transparent and stable.

This paper confirms that the tax revenue in SAR lags behind that in other regions, and generates inadequate resources to finance infrastructure and other developmental needs of the region. Tax ratios have remained stagnant despite the fact that the ongoing reforms in tax structure have been broadly consistent with the international norms; and calibrated as per the advice of the multilateral intuitions; and in line with the academic literature.

The reasons for low tax collections in South Asia seem to have much to do with the narrow tax base. While reforming the tax structure has proved relatively easier, widening the tax base has proved to be a bigger challenge. There are multiple reasons for the narrow tax base, some of which are outside the realm of tax policies. Exemptions, rate differences and tax concessions have eroded the tax base and reduced revenue productivity. In some cases they have also altered relative prices and resource allocation between different activities, industries and regions. The influence of special interest groups and pursuit of multiple objectives has led to significant distortions as well. One feature which seems to particularly affect SAR countries is the stubbornly low number of tax payers, e.g. in India only 3 per cent of population pays the personal income tax (out of which 89 per cent of the tax payers pay less than Rs. 500,000 in taxes). Equally staggeringly, the number of taxpayers who declare their incomes to be more than Rs. 10 million is just about 42800 in a population of 1.2 billion.

The situation is not quite different in other countries in the region. In Pakistan barely 3.1 million people and only 47,800 companies possess tax numbers (as compared to 400,000 industrial electricity connections) and yet a much smaller number (about 16,500 companies) file tax returns. Less than 1 percent of Pakistan's population files for income taxes (interestingly, about 70 percent of legislators do not file income tax returns). Taxpayers evade taxes by simply not filing tax returns or by paying low taxes due to special privileges obtained. Even though compliance has improved due to electronic filing, it remained low in

2010-11. Tax payments are concentrated among few taxpayers.¹¹ In 2007, about 90 percent of GST was paid by only 3 percent of taxpayers. A large proportion of corporate income and trade taxation comes from a few large corporations and manufacturing firms and imports of a small number of commodities.

Table 4: Estimated Number of Income Tax Payers in South Asian Countries

Country	Personal Income Tax Payers	% of Population	Year	Population	Source, URL
Bangladesh	2 mln	1.3	2009	149 mln	http://bangladeshbudgetwatch.wordpress.com/2009/09/02/bangladesh-has-an-estimated-2-0-million-taxpayers-dfid-partners-with-nbr-to-bring-%E2%80%98sea-change%E2%80%99-in-taxpayers-service/
Bhutan	46,440	6.5	2010	716,939	http://www.mof.gov.bt/publication/files/pub1wl2585hd.pdf
India	33 mln	2.8	2011	1.2 billion	http://pibmumbai.gov.in/scripts/detail.asp?releaseId=E2012PR3272
Nepal	232689	0.8	2013	27 mln	http://www.imf.org/external/np/seminars/eng/2013/asiatax/pdfs/nepal.pdf
Pakistan	1.7 mln	1.0	2011	176 mln	http://www.thetrueperspective.com/2011/03/shocking-facts-about-pakistani-income.html
Pakistan	2.2 mln	1.2	2012	179 mln	https://www.imf.org/external/np/seminars/eng/2012/asiatax/pdf/asad.pdf
Sri Lanka	194,000	0.9	2011	21 mln	http://www.ird.gov.lk/notice2.html
Sri Lanka	897,000	4.4	2012	21 mln	http://www.lankabusinessonline.com/news/sri-lanka-in-bid-to-boost-income-tax-payers/1757075529

In a population of nearly 150 million, Bangladesh has only a couple of million registered income taxpayers and 300,000 of these file taxes (as per the National Board of Revenue). In Sri Lanka in a population of about 21 million, less than 200,000 file personal income taxes. Sri Lanka's tax authority, Sri Lanka Inland Revenue, reports that "despite the fact that the system of paying tax on the basis of self-assessment is operative for a long period of time there is still a large number of persons who are liable to pay taxes and [do not]..."

In view of the substantial benefits that additional revenue can bring to the severely resource constrained governments of SAR, and the mixed success in attaining similar outcomes through past reforms, there is need for second generation of tax reforms in the region. The reforms should be comprehensive in scope and consist of not just tax policy reforms, and limit not just at the federal level, but should extend to the subnational governments as well. They should focus on strengthening tax administration and improving compliance; and broadening the tax base by rationalizing exemptions, increasing coverage, and through broader structural reforms. Expectedly there are country level specificities and challenges unique to each country in generating larger tax revenues, which we discuss in the box below.

¹¹ This discussion draws on World Bank, Mobilizing Revenue, June 2012.

Box: Tax Revenue, Tax reforms, Challenges and Reform Priorities in South Asian Countries

<i>Country</i>	<i>Trends in Tax Revenue</i>	<i>Tax Rates and Structures</i>	<i>Tax Administration</i>	<i>Structural Factors</i>	<i>Reform Priorities</i>
Pakistan	Tax-to-GDP has declined and is among the lowest at 9.7 percent of GDP (in 2013). Trade tax revenue has declined; there has been modest improvement in the collection of direct tax in the last decade, but not in indirect taxes.	Lowered and harmonized CIT and PIT. Though PIT has many tax brackets and can be rationalized further. The top tax rate in CIT is higher than the top PIT, and need to be harmonized. Narrow tax base due to extensive exemptions and evasion is a serious problem.	Among the worst performers in tax administration in SAR, and a poor performer globally.	Structural factors heavily stacked against robust tax collections, including a high share of agriculture in GDP, low literacy, low urbanization, corruption, poor regulatory quality, large informal sector, low formal finance.	Need comprehensive and multipronged reforms spanning tax administration, regulatory reforms and governance reforms. Provinces need to generate larger revenues; tax administrative capacity in provinces needs to be strengthened.
Sri Lanka	Tax-to-GDP is low and has declined, especially lags in collecting direct taxes. The direct tax-to-GDP ratio has been flat. Indirect taxes ratio has declined even though the rates are not very high.	Has had difficulty in making up the revenue loss on account of past tax reforms; CIT rate structure considered complex: different sectors assigned different rates, concessionary rates to many industries has eroded the tax base. Trade tax collection is higher than the international average.	Frequent and adhoc changes in tax rates have affected tax collection. Tax structures are considered complex. Compliance of income tax is poor. VAT has not generated larger revenue due to exemptions and poor execution.	Structural factors, governance and regulatory quality inhibit larger tax collection. While Sri Lanka is ahead of other countries in the region on governance and regulatory quality, but lags in absolute standards.	Extensive exemptions, frequent and adhoc changes in tax policies have undermined tax compliance.
Bangladesh	After increasing for several years, tax to GDP ratio has stagnated in the past three years. The ratio of direct taxes to	Some progress in the implementation of VAT. Average import tariffs are still considered high. Lags in the collection of	Launched the automated issuance of taxpayer identification numbers. Tax disputes resolution	Governance and regulatory quality inhibit tax collections, and frequent political strikes (known as	Should improve VAT for better indirect tax collection. Tax administration and enforcement should be strengthened, better coordination

	GDP has increased, but both direct and indirect taxes remain below international norms.	direct and indirect taxes.	mechanism system is lengthy.	hartals) further impact revenue collection.	needed between direct and indirect tax authorities.
Afghanistan	Significant improvements in tax-to-GDP ratio, but can be increased further. It lags in the collection of direct and indirect taxes.	There have been discussions to move to VAT, but progress has been limited.	Due to decline in revenues, the Ministry of Finance has changed leadership and senior staff in the revenue and customs department.	Recent declines in revenue collection have been attributed to institutional weaknesses.	Need to continue to widen its narrow tax base.
Bhutan	Tax-to-GDP has increased; trade taxes are high formally but not in practice since trade is mostly with India under free trade agreement.	A personal income tax was introduced in 2002, although large rate cuts were later passed by the National Assembly.		Lack of economic diversification has hampered efforts to broaden the tax base.	Revenues depend on a single sector hydropower, revenue sources should be diversified for stable and larger revenue generation.
India	After increasing for several years, tax-to-GDP ratio has stagnated in recent years. Share of direct taxes in total tax collection has increased. Collection of direct and indirect taxes is in line with the international norms at similar income levels, but property taxes are below average.	Tax reforms started in early 1990s, and continued in the past two decades. Share of trade taxes in total revenue has declined, while the share of direct taxation has increased. Reforms broadened the tax base, lowered rates, reduced their dispersion, and made administration simpler and more effective. Indirect taxes were reformed by transforming excise taxes to VAT.	Strengthened tax administration, use of information technology; tax deduction at source; strengthened information and accountability systems through the issuance of permanent account number and Tax Information Network; several measures to improve compliance.	Some improvement in structural factors which are associated with larger tax to GDP ratio but more rapid governance and structural reforms are needed to maintain the tax-to-GDP ratio.	VAT considered fragmented, rates and administration differ by states. Preparation is underway to implement Goods and Services Tax which is likely to boost revenues by reducing distortions and creating a single Indian market for goods and services. Direct Tax Code is expected to be updated soon.

Maldives	Increased its tax ratio, due to robust indirect tax collection, increase in trade taxes, aided by modest increase in direct taxes. Tax ratio can be increased further.	Trade tax collection is considered high compared to cross country averages, while it lags in the collection of direct taxes. A tourism goods and services tax was implemented in 2010; business profit tax and general goods and services tax were also introduced.	Received technical assistance in September 2010 on tax administration reforms, particularly on the extent of preparedness for new tax regimes.	Structural factors including governance and regulatory environment are somewhat more conducive to higher tax generation	Tax collection is concentrated in a few activities, a large proportion of the tax revenue is from tourism, this being the main activity of the economy. For sustainable tax collection sources must be diversified.
Nepal	Increased its tax-to-GDP ratio impressively over the past decade; among the best performers in the region. Collection of direct as well as indirect taxes has increased; maximum gains have accrued in the collection of indirect taxes; trade tax collection is close to the global average.	Nepal has done well in transitioning from reliance on customs tax revenue to other forms of taxes and in strengthening its tax administration. It has put in place a diversified set of taxes and derives its tax revenue from a combination of direct and indirect taxes: income tax, corporate income tax, VAT, taxes on imports. Import duty collections have been robust due to increase in imports (financed by remittances, and may not prove sustainable).	Nepal has undertaken sweeping tax administration reforms including partially moving to an e-system that allows for online registration and filing; and establishment of a large tax payer unit.	Further increases in tax-to-GDP are likely to be hampered by a large agriculture and informal sector, as well as by poor governance and regulatory capacity.	Tax generation from income taxes remains low and can be increased further. There is still considerable scope to increase tax-to-GDP ratio by eliminating exemptions (including on corporate income tax), expanding the tax base and increasing tax compliance. Non-filers are estimated to be almost half the eligible tax payers for income tax.

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Appendix A

Tax revenue: In Table A 1 we present the annual time series of the ratio of tax-to-GDP in South Asian countries.

Table A1: Tax Revenue/GDP in SAR Over Time

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Afghanistan					7	6	6.1	8.6	9.4	9.3	8.6	8.8
Bangladesh	7.7	8.3	8.2	8.5	8.5	8.2	8.8	8.6	9	10	10.4	10.4
Bhutan	9.7	9.5	7.7	9	9.5	8.2	9.4	10.9	13.5	12.9		
India	13.9	14.6	16.9	16.4	17.5	18	17	15.2	15.1	15.5	15.1	15.8
Maldives	10.3	10.4	12	13.6	14.2	14.7	13.9	10.8	10.7	15.5		
Nepal	9.3	9.5	9.7	10.2	10.9	9.9	10.5	11.8	14.8	14.4	15.7	15.8
Pakistan	10.9	11.4	10.8	10.1	10.6	11	10.4	10.5	10.1	9.6	10.2	9.7
Sri Lanka	14	13.2	13.9	14.2	14.6	14.2	13.3	12.8	12.9	12.4	11.1	11.7

Note: Sources are various International Monetary Fund country reports, Government Finance Statistics.

General government tax revenue is used for Bhutan, India, Maldives, and Pakistan. Central government tax revenue is used for Afghanistan, Bangladesh, Nepal, and Sri Lanka.

Total revenue (tax and non-tax revenue): The ratio of total public revenue to GDP has evolved similar to tax-to-GDP ratio in SAR.¹² While it has remained steady in Bangladesh, India, Pakistan, and Sri Lanka; Afghanistan and Nepal have seen increases in the past five years, while the ratio has fluctuated in Bhutan and the Maldives.

Table A2: Public Revenue/GDP in SAR over time

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Afghanistan	8.2	11	14.3	18.1	18.3	19.9	17.5	20.5	22	22.3	25.2	26.1
Bangladesh	11.1	11.4	10.6	10.9	11.1	10.8	11.3	10.8	11.5	11.9	12.9	13
Bhutan	36.4	25.6	34.3	30.7	34.7	35.7	34.9	32.8	46.3	35.6	35.5	29.2
India	17.8	18.2	18.9	19.1	20.3	22	19.7	18.5	18.8	18.8	19.4	19.6
Maldives	25.6	25.2	24.7	36	36.6	38.2	30.6	22.5	23.8	30.8	30.3	43.8
Nepal	12	13.3	13.3	14	13	14.2	14.9	16.8	18	17.6	18.6	19.9
Pakistan	14.7	16	13.6	13.1	13.6	14.4	14.4	14.2	14.3	12.6	13.1	13.2
Sri Lanka	16.4	15.6	15.3	16.8	17.3	16.6	15.6	15	14.9	14.5	13.2	13.5

Note: Source is IMF WEO, extracted in October 2013. General government public revenue data are presented.

¹² Non tax revenues include interest earnings, property income, user fees, profit transfers and dividends from state owned enterprises.

Table A3: Composition of Tax Revenue in South Asian Economies

Composition of Taxes in SAR in 2000 (% of GDP)

Country	Total Taxes	Taxes on Income, Profits, and Capital Gains				Taxes on Trade	Sales Taxes and VAT	Property Taxes	Other Taxes
		Total	<i>Individuals</i>	<i>Corporations</i>	<i>Other</i>				
Afghanistan	2.43	0.16	0.09	0.07	0	2.03	0.13	0.02	0.09
Bangladesh	7.60	1.21	0.52	0.70	0	3.28	2.63	0.04	0.44
Bhutan	11.09	5.93	1.25	4.67	0	0.40	4.73	0.04	0
India	14.48	3.23	1.51	1.70	0.02	2.75	8.42	0.06	0.01
Maldives	13.80	0.64	0.00	0.64	0	8.88	4.09	0.00	0.18
Nepal	8.74	1.84	0.49	1.17	0.18	2.85	3.63	0.30	0.12
Pakistan	10.09	2.83	0.42	2.33	0.08	1.61	4.51	0.1	1.02
Sri Lanka	14.50	2.18	0.93	1.25	0	1.91	9.76	0.6	0

Composition of Taxes in SAR in 2012 (% of GDP)

Country	Total Taxes	Taxes on Income, Profits, and Capital Gains				Taxes on Trade	Sales Taxes and VAT	Property Taxes	Other Taxes
		Total	<i>Individuals</i>	<i>Corporations</i>	<i>Other</i>				
Afghanistan	7.65	2.48	0.95	1.34	0.19	2.81	2.05	0.24	0.07
Bangladesh	9.98	2.76	1.18	1.58	0	3.03	3.82	0	0.38
Bhutan	10.91	6.33	0.75	5.58	0	0.39	4.13	0	0.05
India	15.18	5.38	1.80	3.59	0	1.22	7.26	0.06	1.26
Maldives	15.49	0.84	0.00	0.84	0	8.19	5.25	0.03	1.19
Nepal	13.78	3.34	0.80	1.99	0.55	2.82	7.20	0.23	0.19
Pakistan	9.80	3.61			0.07	1.04	4.80	0.0	0.35
Sri Lanka	11.99	2.28	0.28	1.21	0.79	2.86	6.49	0.0	0.36

Note: Source is Government Finance Statistics. Data is cash-basis budgetary central government, with the exception of India, which is cash-basis general government. Direct taxes include taxes on income, profits, and capital gains, while indirect taxes include sales taxes, and VAT.